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India: Economic Growth and Poverty Reduction During the 1990s

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Abbreviations and Acronyms

BJP	Bharatiya Janata Party
CMIE	Center for Monitoring the Indian Economy
EIS	Economic Intelligence Service
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
GDP	Gross Domestic Product
GSPD	Gross State Domestic Product
IMF	International Monetary Fund
IT	Information Technology
NAS	National Account Statistics
NSS	National Sample Survey
NSSO	National Sample Survey Organization
PSE	Public Sector Enterprise
UF	United Front

Overview

The fiscal crisis that struck India in 1991, as the result of myriad internal and external factors, compelled the nation to adopt a series of economic reforms and liberalization policies. The genesis of the fiscal crisis lay partly in the highly protected domestic economy that maintained extensive subsidization, licensing and investment regulations, thus placing considerable burdens on the expenditures of the central government. Compounding this problem was a rapidly expanding current account deficit that had grown over time as import demand steadily increased and exports and foreign investment lagged. These conditions, in combination with external factors, generated a severe balance of payments crisis in which India came perilously close to defaulting on loans from international lenders. Under the leadership of Prime Minister Narasimha Rao and Financial Minister Manmohan Singh, the Indian government initiated a series of macroeconomic reforms. This included reductions in fiscal expenditure, privatization of state-run industries, promotion of foreign investment, and liberalization of international trade policy.

A decade later, attention focuses on the outcomes of these reforms with respect to economic growth and poverty reduction. Transfer of limited economic autonomy through decentralization of political power has occurred at varied rates across states, although substantial difficulties in policy coordination and implementation continue to exist. Those states most dedicated to reform have achieved the highest rates of growth while experiencing the most significant declines in poverty over time. Alternatively, many of the traditionally poor states have lagged in reforms and have seen minimal improvements in poverty reduction. Economic liberalization must be enhanced at the national and state levels, in concurrence with more efficient expenditures on social development (healthcare, education and infrastructure). By pursuing such measures, opportunities will be enhanced for the nearly 300 million Indians living in poverty today.

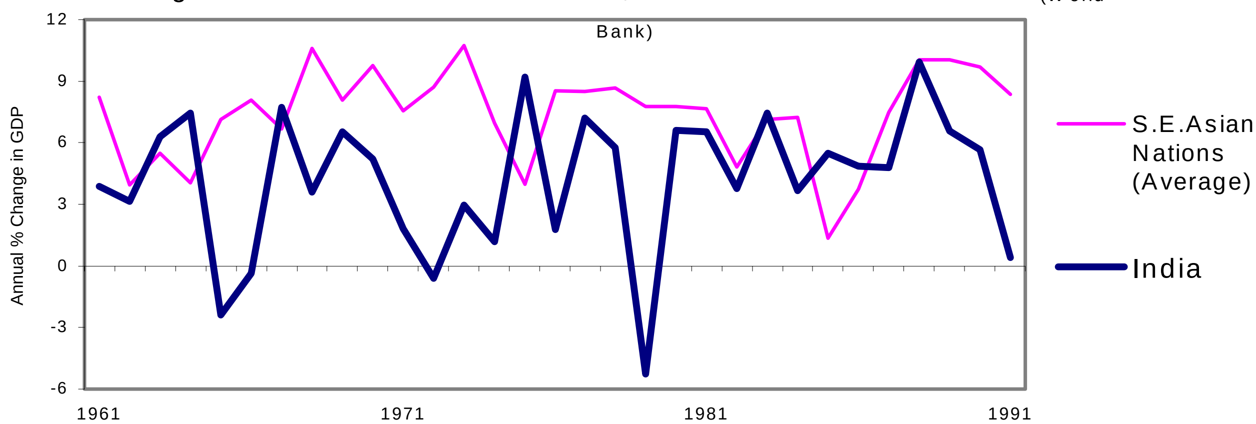
The following study traces the evolution of the fiscal crisis, then identifies and discusses several key reforms to emerge from this experience. Subsequently, the impacts of the reforms are examined, with consideration paid to their outcomes for economic growth and poverty reduction at the national and state levels. Overarching the economic developments is an analysis of the emerging socio-political factors that have been integral in shaping policy formulation.

40 Years of Protection and Isolation

Subsequent to its emergence as an independent nation in 1947, India faced a multitude of economic and social problems. Years of British colonial rule had fostered an inefficient and largely stagnant pattern of growth in which the industrial and agricultural sectors were generally unproductive. The degree of poverty by the latter 1940's was staggering, illiteracy rates were nearly 80 percent, famines were a recurrent event, and fertility rates averaged approximately 7 children per woman. Under the leadership of the first Prime Minister, Jawaharlal Nehru, a broad socialist framework was embraced, one which respected social justice while promoting an agenda of rapid economic growth. For the economic planners of this time, "accelerated growth was regarded as…a policy outcome that would in turn reduce poverty, which constituted the true objective of our efforts" (Bhagwati 1998). Indeed, many were confident that the nation's welfare could be improved through the framework of five-year plans—centralized planning strategies for resource allocation and production activities. Public sector investments were initially concentrated in the creation and maintenance of heavy industries such as cement and steel. Ultimately the most important spheres of the economy would come under direct or partial control of the Central government.

Nehru's preoccupation with India's economic and industrial development was the result of a conviction that the future of the country lay in establishing a strong industrial and modern technological state (Panandiker 1998). This encouraged policies that protected the domestic industrial sector from competition, regardless of the inefficiencies incurred. The government engaged in extensive degrees of planning and regulation, including pervasive controls over industries and heavy restrictions on foreign investment. Such policies in the formative years of the new state set the tone for the development agenda over the next forty years and had major implications in the economic, political and social realms. In the decades following independence, per capita GDP in India fluctuated considerably, but rose by an average of only 1.5 percent per year. Compared to several neighboring Asian countries, whose growth averaged over 7 percent per year across the same duration, India's rate was significantly slower (Figure 1). Many of the government's economic policies and practices contributed to the stifling of GDP growth over this period.

Figure 1: Annual % GDP Growth, India & S.E. Asian Nations (World Bank)



Vast public ownership

The Industrial Policy Resolutions of 1948 underscored the need for "the State to play a progressively active role in the development of industries while evolving a dynamic policy towards a continuous increase in production by all possible means" (Sarma 1997). This effectively secured the preeminence of public sector enterprises (PSEs) in fiscal budgets for decades to come. The objectives of the PSEs, as outlined by Sarma (1997), were multifold:

- "Development, employment, equity, growth and self-reliance
- Provision of merit goods
- Ownership of natural monopoly
- Contrived monopoly in strategic sectors
- Diffusion of private enterprises and prevention of non-competitive practices…
- Conservation of productive capital and preservation of employment"

In adherence with these policies the government classified Indian industries under three categories: those whose development was the exclusive responsibility of the state, those that would become progressively state-owned and those industries that were left to private sectors for development (Sarma 1997). By the late 1980s, India's public enterprises "dominated many sectors of the economy," including transportation, telecommunications, manufacturing and power generation, transmission and distribution (Gupta 2000). These enterprises employed vast numbers of workers (typically unionized) in key political districts; thus, politicians received strong voter support in elections for additional job creation within the public sector. Despite criticism that PSEs were chronically overstaffed and incurred other inefficiencies in operations, little was done to improve their performance.

Extensive Subsidization

The existence of subsidies has traditionally been supported on the basis of economic ideology, but in reality has endured for the most part out of political necessity. As one economist points out, "the political economy of food compelled our policy makers to periodically look back to agriculture, whenever the specter of hunger loomed large or donors (under PL 480) twisted our arms" (Gulati 1998).[1] These programs extended beyond agricultural sectors however, to include supports on exports, electricity, oil and irrigation water. By the late 1980s, government subsidies on economic services were estimated at about 4.5 per cent of GDP. Explicit subsidies comprised 1.5 per cent of this figure, with the remainder allocated to industry, transportation and communication sectors (Joshi 1998). In addition, state subsidies amounted to nearly 4 percent of GDP, and included support for irrigation and power. Subsidy recipients developed reliance upon this assistance and mobilized vehemently around any efforts to reduce or abolish the subsidies. Politicians, with full knowledge of the ramifications of such backlashes, were historically reluctant to alter these programs significantly.

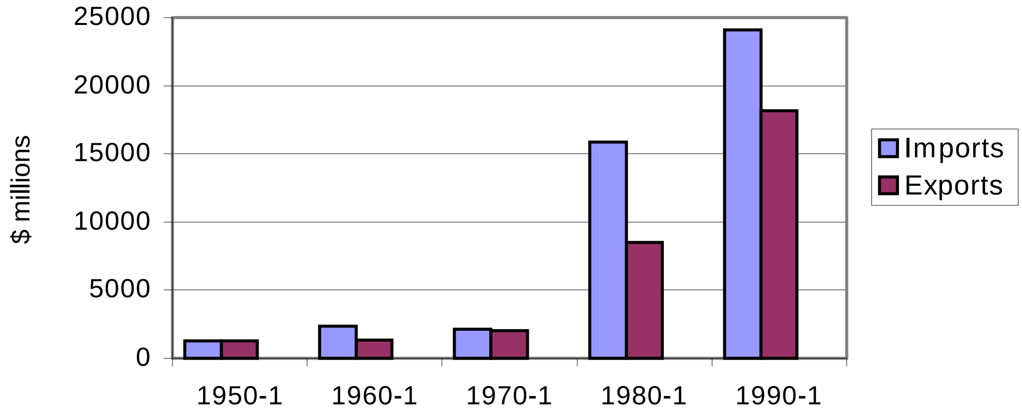
High trade barriers

The substantial barriers to trade imposed after India's Independence were partly motivated by the century's earlier developments, which had profound consequences on the nation's economy. As one observer notes: "the collapse of free trade and the global trading system between the two world wars, a misidentification of foreign trade with imperialism and of free trade with the failure of colonial authorities to promote industrialization …led to the adoption…of an inward-oriented development strategy of which exports had not been regarded as an integral part" (Srinivasan 1998). The lessons taken from these experiences contributed to India's view that expanding export earnings was impossible. This belief, augmented by assurances from economists that import substitution could resolve the nation's balance of payments problem, led the government to impose stringent regulations on imports. This included maximum tariffs of over 300 percent and average (import-weighted) tariffs of 87 percent; on consumer goods imports, the import-weighted average tariffs were as high as 164 percent (Srinivasan 2001).

The government also implemented other forms of trade restrictions. By 1990, non-tariff barriers were imposed on imports of 65 percent of all goods (and 90 percent of manufacturing) Srinivasan 2001). Qualitative restrictions—which were applied to practically all imports—became the primarily means for controlling import levels. While these measures constituted major revenue raising devices for the government (3.6 percent of GDP in 1990-91 from total tax revenue of 9.5 percent of GDP), the multiple layers of overlapping, mutually reinforcing

[1] For discussion of implications of PL 480 see Gulati, A. (2000) 'Indian Agriculture: Emerging Perspectives and Policy Issues' in *Indian Economy Since Independence*.

Figure 2: Indian Imports / Exports 1950 -1990 (Ministry of Finance)



restrictions were detrimental to the growth potential for the economy (Srinivasan 2001, World Bank 2000a). These restrictions ensured that between the 1950s and early 1980s India would maintain very low levels of trade, and remain in near isolation from the world's trading network (Figure 2).

Restrictive industrial policies

Industrial policy had been heavily regulated and restricted since India's independence. Expansion and diversification were controlled through industrial licensing, import levels were controlled though import licenses, and access to savings via banks and financial institutions were controlled through various policies and legislative provisions. The Industries (Development and Regulation) Act (1951) designated firm licensing and regulation policies, which were dependent upon workforce size and energy usage. Licenses were required when companies initially formed and whenever they sought to diversify or expand. The licensing mechanism became "the most important instrument for rewarding and punishing industrialists" and over time created a caste system that included PSEs, small and large industries, and companies belonging to business houses. Licensing policies were used to match supply and demand, which inhibited the emergence of competition and enabled large firms to engage in cost-plus pricing and ignore improvements to productivity. As a result, Indian firms typically had high capital-output ratios, which were reflected in the negative growth of total capital productivity from the 1960s-1980s (Desai 1999). To prevent competition from external sources, companies lobbied against licensing to foreign businesses and increased their protection through the Foreign Exchange Regulation Act, which required all foreign firms to reduce shareholdings in Indian subsidiaries to less than 40 percent, unless the government allowed otherwise (Desai 1999). Private investment from households was diverted from industry to the public sector (predominately agriculture) to meet consumption requirements, which further reduced opportunities to enhance the industrial sector.

The government's adherence to these protectionist and isolationist policies over a sustained period had tremendous ramifications on the economic, political, and social fabric of the nation. State-led development in India insulated the economy from global forces and simultaneously allied the government with the business and landowning classes, politicians, and the bureaucratic elite, all of whom reaped major financial gains from the design of the domestic policy agenda, an agenda that contributed at the same time to persistent unemployment, minimal improvements in education and healthcare, and general economic stagnation for much of the remaining population.

The Impending Crisis

Though India had experienced minimal economic growth since independence as a result of decades of inefficiencies and mismanagement, the economy showed modest signs of improvement in the early 1980's. As a result of limited liberalization of imports and industrial controls and improved agricultural performance, real per capita GDP growth increased to an average rate of 3.75 percent (Reynolds 2000). Yet this growth was also derived from a debt-financed consumption and investment boom that eventually became unsustainable. Throughout the decade, government spending grew at "a phenomenal rate" surpassing the growth of both GDP and government revenues (Bajpai 1996). Subsidies were a major source of government expenditure: their portion of total expenditure rose from 8.5 percent in 1980-81 to 10.2 percent in 1990-91. In absolute terms, this was the equivalent of nearly Rs. 90 billion. Other large expenditures, including support for PSEs, state grants and defense spending, rendered a self-propelling cycle of spending and borrowing to meet current expenditures. The increasing diversion of household savings to meet public consumption requirements expanded the national debt to levels that were unsustainable and diverted resources away from private markets. By decade's end, declining growth rates, formidable barriers to trade and investment, highly restrictive licensing policies, and inefficient returns from PSEs were creating enormous economic burdens. Under these conditions, public sector spending could not be maintained and the resulting loss in the confidence in the economy created significant macro-instability (Bhagwati 1998).

Trade imbalances over this period were exacerbated by the fiscal expansion and by unforeseen external factors. An increase in large-scale government import expenditures (those on defense, for example) were funded partly through external commercial borrowings, which deteriorated the current account balance directly and via outflows of reserves for interest payments. While import expenditures rose, India's share of exports had plummeted, from 2 percent of the world's share in 1950, to 0.5 percent by 1990; in part this was the result of adverse exchange rate movements, which hurt the competitiveness of domestic exports (Ahluwalia and Little 1998). Extraneous developments also contributed to worsening external imbalances. This included two major oil shocks in the previous decade, followed by the Gulf War crisis during which India's oil bill nearly doubled between 1989-91 (Bajpai 1996). Further, the Iraqi occupation of Kuwait sent nearly 300,000 Indians workers back to their homes, resulting in a substantial fall in remittances. In addition, a substantial outflow of deposits held by non-resident Indians occurred during 1990-91. According to statistics published by the Center for Monitoring the Indian Economy (CMIE), these outflows accelerated from $59 million per month from October-December 1990 to $310 million per month by April-June 1991.

The macroeconomic instability reached a crisis level by 1991. Statistics from this period show a startling portrait of economic conditions:

- The gross fiscal deficit of the central government expanded to 8.3 percent of GDP by 1990-91, from 5.7 percent of GPD in 1980-81 (Bajpai and Jian 1996).
- The annual average inflation rate grew from 7 percent in 1989-90 to 13 percent by 1991-92.
- The internal debt of the government stood at 52.9 percent of GDP at the end of fiscal year 1990-91 from 35.6 percent at end of 1980-81(Bajpai and Jian 1996).
- The government's external debt rose to $70 billion (41 percent of GDP) from $20 billion, (12 percent of GDP) a decade earlier (Bajpai and Jian 1996).

- The current account deficit, as a percentage of GDP, reached 3.24 percent by 1991, equivalent to roughly $6 billion dollars (EIS 2000b).
- Reserves declined from a peak of $5.97 billion in 1985-86 to roughly $2 billion by 1990-91, which covered less than one month's worth of imports (EIS 2000b).

A New Leadership Steps In

A new election ushered in the government of Narasimha Rao shortly before India reached the brink of defaulting on its loans to the IMF and other lenders. Rao's Financial Minister, Manmohan Singh, set about initiating major reforms aimed at stabilizing the economy and ultimately bringing it to a higher growth path. The reforms were driven in part by the dissatisfaction of some political and economic elites, who by the latter 1980s had recognized the need for extensive reforms. These leaders, less nationalistic and socialistic than their counterparts from the Nehru era, attributed their country's slow growth to the extensive governmental controls and insulation from international trade (Kohli 2000). Gradually, these leaders were also coming to recognize that the immense poverty that existed in their society could not provide adequate markets for the expansion of industry and manufacturing. Participation in the global economy was necessary to make future economic growth viable. Thus, the New Economic Policy of 1991 was expected to mark "a major and irreversible shift from a political/administrative to a market-based ethos in Indian economic policy making" (Desai 1998). At the national level, the government undertook liberalization policies that included fiscal reform, privatization of industry, promotion of foreign investment policy, and expansion of international trade. Limited decentralization at the state level enabled the initiation of deregulation and development of private investment policies suitable to the unique socio-economic geographic characteristics of each state.

Key Areas of Reform

The endurance of democratic institutions in India, despite a highly stratified and diverse populace, has undoubtedly been one of the country's greatest assets. It provides opportunities for active engagement and involvement of the citizenry in a variety of capacities at multiple levels of the government. The decision-making process in India is thus a complex and intricate network of consultations and discussions between government officials, bureaucrats and elites, interest groups, media and intellectuals, and the political parties. During the liberalization process these actors attempted to guide the formulation and implementation of the reforms.

Fiscal Reform

As discussed previously, reform efforts were designed to stabilize and strengthen economic performance, and thereby induce greater investment from internal and external sources. The government set a target for reducing the fiscal deficit from 8.4 percent to 6.5 percent of GDP. To achieve this target it was necessary that profligate fiscal spending, a major cause of the macro-instability, be restrained and that government revenues be increased. One of the critical changes was a reduction in funding and transfers to the states. Subsidies were abolished to the export sector and sugar industry, and reductions were made on fertilizer subsidies. Defense expenditures were also reduced during the initial phase of reforms. To generate revenues the government raised oil prices, increased the corporation tax by 5 percentage points and raised some excise duties. Cuts in expenditures were also undertaken at the state level; however, there were wide variations in the breadth and scope of these policies. Andhra Pradesh decreased food subsidies and adjusted water and power rates; Gujarat implemented tax and expenditure reforms; Maharashtra has developed an approach that transforms the role of the government into that of a facilitator (rather than a controller) in order to shift many of the infrastructure responsibilities to the private sector (Bajpai and Sachs 1999). Throughout this process, critics maintained that the potential political backlash from interest groups had remained of paramount concern in the minds of the reformers hindering development of a more comprehensive strategy for improving fiscal conditions.

Privatization

The privatization of public sector enterprises was considered a crucial facet of the reform process. According to the Ministry of Disinvestment, the selling off of government shares in public enterprises were designed foremost to release "the large amount of public resources locked up in non-strategic PSEs, for redeployment in areas that are much higher on the social priority, such as basic health, family welfare, primary education and infrastructure…stem further outflow of scarce public resources for sustaining the unviable non-strategic PSEs…reduce the public debt…transfer the commercial risk [from the taxpayers] to the private sector [and] release other tangible and intangible resources, such as large manpower currently locked up in managing the PSEs and their time and energy for redeployment in high priority social sectors that are short of such resources."[2] Secondary benefits expected to result from the privatization included: enhanced efficiency of companies introduced to market discipline/market forces, wider distribution of wealth to small investors and employees, improvements in the capital market, increased economic activity, employment and tax revenues in medium and long term, and greater public choice (and reduced costs) for consumers (Ministry of Disinvestment).

The privatization process is multi-faceted and has occurred in a series of stages. While initially up to 20 percent of the government's equity in selected PSEs was to be *divested* in favor of "public sector institutional investors", by 1993, majority government ownership was restricted to only six key industries, though at lesser levels a series of limits on public ownership remained. Loss-making firms were referred to the Bureau of Industry and Financial Reconstruction, which would assess their potential for rehabilitation or closure, eliminating the guarantees against closure that had been standard practice. In the budget speech of 2000-01, the government proposed reducing its stake in non-strategic PSEs below the existing minimum of 26 percent, with a pledge that "the entire proceeds from disinvestment/ privatization would be deployed in social sector, restructuring of PSEs and retirement of public debt" (Ministry of Disinvestment). These efforts have been important steps in the removal of barriers to entry for private firms and have provided the potential for considerable growth of numerous industries in the future.

At the state level, numerous policies have been adopted to further the privatization process. The Gujarat government has taken important steps towards privatizing state-owned enterprises including creation of the Gujarat Industrial Investment Corporation, which is responsible for supervising private sector infrastructure projects. Maharashtra and Andhra Pradesh have also initiated reform of the state-owned enterprises, although much must still be done to further privatization. Haryana and Orissa have undertaken crucial reforms in the power

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[2] See the Ministry of Disinvestment homepage for further discussion of privatization process and updated statistics on privatization progress www.divest.nic.in/index.htm.

sector, including the unbundling of the state electricity board (Haryana) and establishment of a electricity regulatory commission (Orissa).

Foreign Investment Policy

Foreign investment policies were "drastically transformed" during the initial stages of the reform process in order to build the confidence of international investors (Ahluwalia and Little 1998). The government's perspective on foreign investment—at both the central and state levels—was significantly altered by the reforms: policies were now designed to actively seek out foreign direct and portfolio investment. Therefore, efforts were made to simplify the rules and procedures of investment and offer terms that were better aligned with international standards. The restrictive policies maintained by the Secretariat for Industrial Approvals had traditionally excluded most foreign investment opportunities. As a result of the reforms, two new committees were established: the Foreign Investment Promotion Board (FIPB), which vets external investment proposals, and the Foreign Investment Co-ordination Committee, which then determines approval for the proposals. Initially, approval was to be automatically granted for 51 percent foreign investment equity participation and technology agreements in 34 high priority industries (in May 2001 this was expanded to 100 percent foreign investment, though restrictions to certain industrial sectors continued) (Srinivasan 2001). Critically, governments at the state level were now empowered to attract multinational companies to invest in infrastructure projects, long neglected but now vital for sustainable growth in the future. Progress in this area has been highly concentrated in southern and western regions, which possess substantially higher levels of human development and infrastructure and thus are capable of attracting more investment opportunities. The states of Karnataka, Maharashtra and Tamil Nadu are providing incentives for investment in infrastructure and the information technology industry, while Bihar, Uttar Pradesh, Madhya Pradesh and Rajasthan have attracted only marginal investment.

'Opening Up' International Trade Policy

Liberalization of international trade policy was a pivotal aspect of the national reform measures. Efforts were concentrated on reductions to import licensing, tariffs and excise taxes. Initially, eximscripts[3] were issued to exporters to simplify import licensing, but these slowed the efficiency of transactions and were easily forged, and thus were abolished in 1992. They were replaced with special import licenses given for a share of export earnings, which could be applied towards import of certain agricultural and consumer goods. The government introduced a dual exchange rate under which 40 percent of exporters' exchange earnings had to be surrendered at the official exchange rate and the remainder at a market-determined exchange rate. Importers were permitted to buy foreign exchange from banks at the market rate—which effectively transferred exchange control on trading to these institutions. Standard Import licenses on capital goods were abolished, but remained on agricultural and consumer goods (Desai 1999). Rupee devaluation came in June of 1991 and rates fluctuated between RS 30 and 32 by the following year when the dual exchange rate was introduced. With aid from IMF, reserves climbed and the budget of 1993 unified the exchange rates.

Tariffs reductions were another aspect of the reforms. The maximum tariff was lowered from 350 percent to 150 percent in June 1991, and then further reduced over the next six years, down to 40 percent in 1997. Other rates below the maximum were also reduced over this time,

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[3] Eximscripts provided import entitlements against export earnings; see Desai 1999 for further explanation.

although the majority of the adjustments were made in the three years subsequent to the initial reduction. Import-weighted tariff rates, which stood at approximately 87 percent in 1990-91, were eventually brought down to almost 30 percent by 2000, and are expected to lower by 10 percent between 2001-04 (IMF 2000, Srinivasan 2001). Despite such improvements, India's tariff rates remain significantly higher than those in several other developing countries.[4] Quantitative restrictions on imports of most intermediate and capital goods were abolished by April 2001, though as a result tariffs in some sectors (notably agriculture) were increased. The state of Karnataka is noteworthy for its considerable progress in trade liberalization. It is orienting itself towards improving export of value-added good and services, particularly from the IT sector, and has made significant investments in infrastructure and human capital in order to achieve this objective.

Impacts of the Reform Efforts

In the years following the initial series of economic reforms and liberalization measures, the Indian economy showed marked signs of recovery and expansion. By 1994-95, growth of GDP was strong (at over 6 percent annually), foreign currency reserves were accumulating at a steady pace, and the export-import ratio had improved. Such encouraging results gave momentum for continued reforms efforts through the mid-1990s. Initially, this process was directed by substantial economic planning and management efforts of bureaucrats and government economists in cooperation with the select group of elites who dominated the social castes and the economic sphere. In this way, the interests of the upper classes remained protected through self-serving policies, particularly within the industrial and agricultural sectors. However, considerable political and social developments over the past decade and a half have significantly, albeit gradually, altered policy formulation and implementation.

For the central and state governments, economic reforms and economic growth in general have been partly determined by the heightening influence of regional political parties and the mobilization of interest groups. Reform-oriented states, with superior infrastructure and resource capabilities, have seized the opportunities offered by heightened autonomy and liberalization to attract private and foreign investment. Evidence provided by Bajpai and Sachs (Table 1) suggests that as a result, these states have experienced stronger economic growth that has boosted tax revenue and led to more substantial improvements in education, health care and other social measures. In the more populous and impoverished states, socio-political movements have slowed the pace of reforms, where at all they existed, and exacerbated disparities in inter-state economic performance. Some nationalists from the Bharatiya Janata Party (BJP) have remained vehemently opposed to multinational firms and have remained highly protectionist in their position on trade liberalization. Regional parties such as the United Front (UF), which represents agrarian and lower-caste voters, are demanding greater subsidization of agriculture and industry (Sridharan 1997). Under such pressures these state governments "have made little effort to introduce change, preferring to rely on the strength of their vote banks to lobby the center for handouts" (EIU 2000). The data from Table 1 underlies the growing tensions between reformists and 'national socialists' over the disparities in states' implementation of reforms and subsequent growth patterns.

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[4] See Pursell (1996), "India Trade Policies Since the 1991/92 Reform," Washington, D.C.: World Bank (mimeo) and World Bank (2000a pg. 70) for comprehensive cross-county comparison of tariff rates.

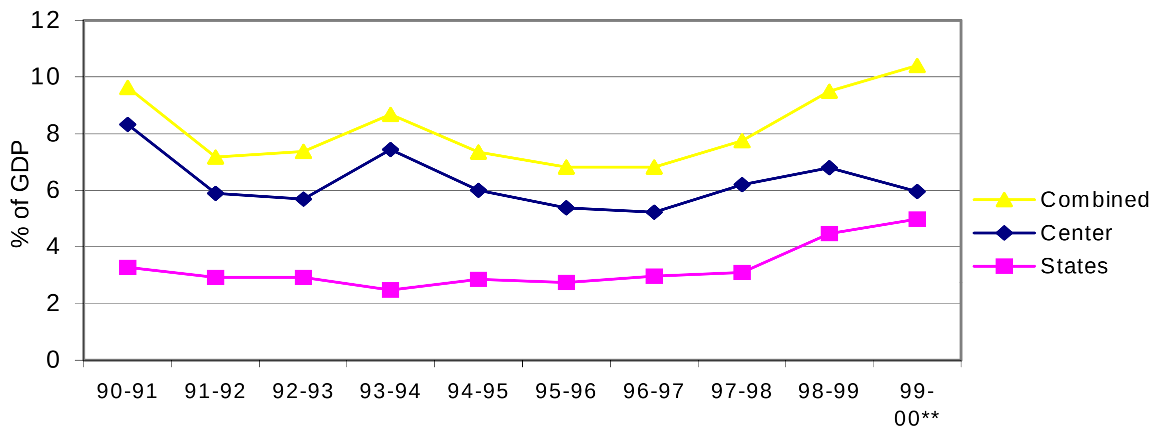
Table 1: State-Level Progress -- Select Economic Indicators (Source: Bajpai & Sachs 1999)

State	**Growth Rate** *GSDP Per-Capita (in %)* *1981-91*	*1992-97*	**FDI Approved** *(Rs. Mn.) Aggregate* *1991-97*	**Software Exports** *(in US$)* *1995-96*
Reform-Oriented States				
Andhra Pradesh	2.9	3.8	25112.73	931.30
Gujarat	3.7	8.4	37625.42	55.10
Karnataka	3.5	3.4	54938.89	7278.40
Maharashtra	4.1	7.4	126763.87	7085.60
Tamil Nadu	4.6	5.2	54687.54	3116.70
Intermediate-Reform States				
Haryana	2.6	2.6	17884.02	629.90
Orissa	1.5	1.5	37907.9	~
West Bengal	4.9	4.9	52495.48	546.90
Lagging Reformers				
Assam	2.0	1.0	14.95	~
Bihar	2.9	-0.7	1307.46	~
Kerala	2.5	4.9	5209.17	38.70
Madhya Pradesh	2.9	4.1	52683.29	2.50
Punjab	3.6	2.8	8212.04	9.00
Rajasthan	5.2	4.9	6054.69	~
Uttar Pradesh	2.9	1.8	24445.19	~

Fiscal Policy Reform

Fiscal expenditure was successfully reduced in the initial reform period, but conditions have deteriorated in recent years, partially undermining progress made thus far and testing the government's commitment to fiscal restraint. The reform measures prompted a reduction in the combined fiscal deficit, from almost 10 percent of GDP in 1990-91 to 7 percent in 1995-96. However by 1996-97 a major slide led the deficit to rise continuously throughout the remainder of the decade. The combined fiscal deficit is currently over 10 percent of GDP (see Figure 3 for Center and state breakdown in the combined fiscal deficit). The components of the Center's fiscal deficit are multi-fold. Subsidies, interest payments, defense spending, and grants to states (which are the major sources of revenue expenditure) have risen to over 70 percent of total expenditure in the 1990s and are expected to comprise nearly 80 percent of total non-plan expenditure by 1999-00. By comparison, they comprised roughly 60 percent in the early 1980s. Interest payments stand out as the largest expenditure in the Union Budget: the share of expenditure devoted to interest payments on the debt has grown to almost 6 percent in 1999-00, from slightly over 4.25 percent in 1990-91. In 1999-00, 83 percent of the gross fiscal deficit was attributed to interest payments, a rise of 35 percent since 1991-92 (EIS 2000a). The share of explicit subsidies in total central government expenditure declined steadily from nearly 12 percent in 1991-2 to approximately 7 percent in 1995-96. Since then, the trend reversed and subsidy expenditure has risen to nearly 8 percent (EIS 2000a). During the same period, the share of subsidies in total GDP has remained stable at approximately one percent (IMF 2000). These figures do not include hidden subsidies or state and local supports, which are nearly equivalent in size to the subsidies from the central government. Pressures persist from regional interest groups demanding greater food, oil, and fertilizer subsidization. Defense spending has grown since 1997, despite a significant reduction during the previous decade, and is anticipated to rise to 22.5 percent of non-plan expenditure by 2001-02. This rise is attributed to financing of the Kargil war and a build up of more modern arms and ammunitions. Fiscal finances have been further strained by the oil shock in the latter 1990s. The government is under pressure not to pass on rising oil prices to consumers at a potential cost of nearly $1.62bn in the coming years. Rising civil service wages and persistent inefficiencies in the government administration and bureaucracy continue to weigh on the budget.

Figure 3: Fiscal Deficit, Center & States (Ministry of Finance, India)



Fiscal reductions have been limited by a lack of corresponding corrections at the state level. Approximately one-fourth of central government spending goes to the states in the form of grants-in-aid, transfers and loan forgiveness and refinancing. These expenditures are extremely difficult for the Center to curtail due to the structure of the current transfer system. Among those reform-oriented states, particularly in the south and west, there is growing resentment towards other states, as well as the Center, for what is perceived as insufficient reductions to fiscal expenditures. The consequences of this emerging tension on the future of Center-state and inter-state relations will be an important development.

Privatization

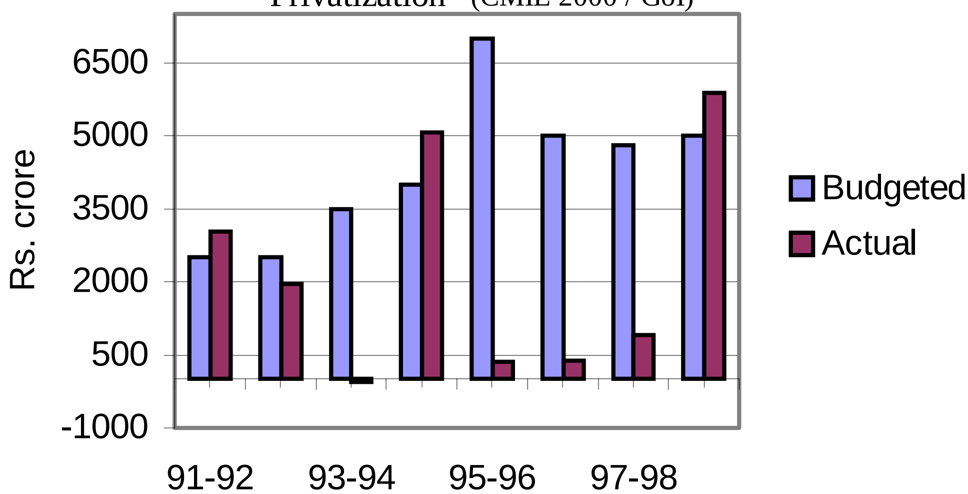
The privatization reforms have affected several sectors of the economy formerly reserved solely for ownership by the central or state governments. Progress has been made through partial-privatization of many industries, though the initial plans for broad privatization have yet to be fully achieved. By 2001 five cases of privatization had occurred representing a broad range of industries (Lagan Jute Machinery Company Ltd., Modern Food Industries India Ltd., BALCO, CMC and HTL). In the decade since 1991 partial-privatization ('disinvestment') has occurred in forty-two PSEs (including the five listed above), representing an aggregate 'disinvestment' of approximately 16 percent equity of these PSEs.[5] The government has realized

[5] See the Ministry of Defense, 'Disinvestment till Now' http://www.divest.nic.in/performance.htm for complete account of privatization record

Rs. 20,261 crore (million) from this process (out of targeted earnings of 54,300 crore). There are currently thirty additional PSEs that the government has approved for ‘disinvestment’ including two national airlines, chemical and fertilizer firms, and steel firms. At the state level, further efforts towards disinvestment and privatization have been achieved, although primarily contained to the south and western states.

Many obstacles still remain in the efforts to reduce government ownership. Massive segments of the labor force—and unions particularly—fear that substantial job loss or foreign ownership may result from greater privatization or private competition. Thus, they have vociferously mobilized to prevent government sale of railways, electricity, oil, coal, telecommunications and several other key sectors. Some politicians expect privatization will

Figure 4: Budgeted & Actual Equity Proceeds from PSE Privatization (CMIE 2000 / GoI)

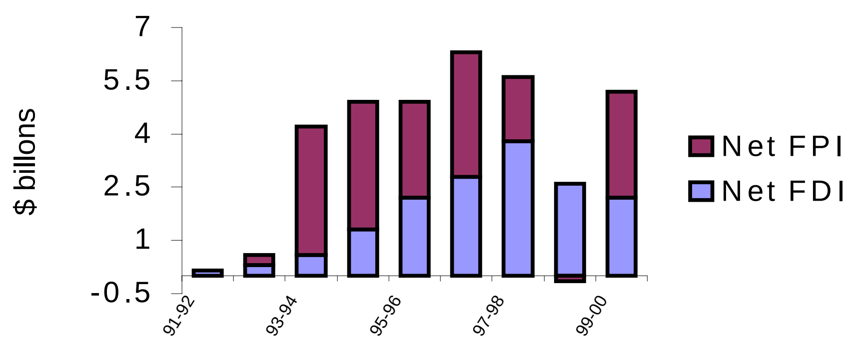


eliminate their control over substantial budgets and are reluctant to support the sale of public enterprises. Bureaucrats have also imposed barriers to sale of public-sector companies as this may introduce job insecurities and eliminate patronage (Desai 1999). Public enterprises are also insulated from privatization by extensive bankruptcy legislation and labor-protection policies, which are designed to sustain their existence. As Figure 4 illustrates, the government’s anticipated proceeds from the sale of equity in public sector undertakings has rarely met the projections set forth by planners. The government recognizes the disadvantages of its sales of minority stakes: “lower realizations because the management control is not transferred [which] signals a lack of commitment to efficient governance of PSEs…with limited holding remaining with the government after minority sales, only small stakes can be offered to the strategic partner, if it is decided to go for a strategic sale subsequently [which] depresses the possibility of higher realizations from the strategic partner, especially since the latter has to offer the same price to other shareholders also through an open offer [and] minority sales also give the impression that the main objective of the government is to obtain funds for reducing the fiscal deficit” (Ministry of Disinvestment). Thus, with the extent of privatization limited thus far, efforts must be sustained and broadened if fiscal improvements are to be achieved.

Foreign Investment Policy

Net foreign investment has grown dramatically in India since reforms were undertaken. Liberalization policies generated a surge of capital inflow during the 1990s (a transition from official debt flows to non-debt foreign investment), despite a steep drop in 1998-99, following the Southeast Asian financial crisis.[6] Net foreign investments grew from $151 million in 1990-91 to over $5 billion in 1999-00, equivalent to roughly 1 percent of GDP for that period (Figure 5). Much of this expansion was concentrated in foreign portfolio investment, which grew from $3,960 million to $9,951 million between 1993-2000. Direct foreign investment (FDI) grew from $651 million to $2,170 million during the same period (EIS 2000b). The government's decision to permit 100 percent FDI in 'special economic zones' for manufacturing companies in a majority of sectors will enhance this growth (EIU 2000). India has been successful in containing the potential volatility associated with portfolio investment, which now accounts for more than 80 percent of total foreign investment (EIS 2000b). Foreign investment now accounts for a large and growing percentage of capital inflow, which is crucial for the success of India's modernization and economic expansion.

Figure 5: Net Foreign Investment (CMIE)



The government should continue the liberalization process to achieve the full potential from investment inflows. A substantial degree of bureaucratic regulation at the middle and lower levels of the Center and state governments still exists. "Unnecessary delays, complexities, obfuscations, and overlapping jurisdictional rights" are discouraging a great number of investors, especially those seeking majority foreign ownership (Srinivasan 1998). In addition, investors are discovering that certain companies do not share the typical performance characteristics of their Asian neighbors or western businesses. In the power sector, the slow pace in establishing reliable payment methods has caused most foreign investors to withdraw. Further, interest groups, including anti-globalization activists are successfully forcing the government to abandon opportunities in FDI within the agricultural sector. Thus, India continues to lag behind many of its South Asian neighbors in terms of attracting FDI.

An important development in the liberalization process has been opening up foreign investment opportunities at the state level. This has enabled inter-state competition for investment, although approval and flows of investment are highly biased towards states in the south and western parts of the country, those with relatively high degrees of human development. Tamil Nadu, Karnataka, and Andhra Pradesh have attracted automobile makers, software giants,

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[6] See the World Bank's Global Development Finance for tables on long term capital flows received by developing countries, including India

and financial firms to their regions. Cities like Chennai, Hydrabad, and Pune are emerging as prominent centers of software development and service industries for multinational firms. The states that have lagged in the reform process, predominately those in the agricultural regions of the north and east have attracted minimal investment. This pattern exacerbates the already wide economic and social disparities that exist between states; therefore, much remains to be done to improve foreign investment policy to attract greater inflows and improve the outward orientation of the Indian economy.

International Trade Policy

Since efforts were initiated to open up Indian trade policy in 1991, economic indicators suggest that reform efforts have achieved some important gains. Liberalization of the exchange rate regime, floating of the rupee and current account convertibility have resulted in significant growth of exports and improvement to the current account deficit. Overall export growth has risen dramatically, especially during the mid-1990s when it reached rates of 18-20 percent per annum. Between 1997-98, exports declined as a result of the Asian financial crisis and adverse agricultural conditions; however, for 1999-00, rates have recovered and export growth was recorded at 13.3 percent (EIS 2000b). This growth resulted in the country's proportion of world

Figure 6: Service exports (BoP, current US$)

(World Bank 2000)

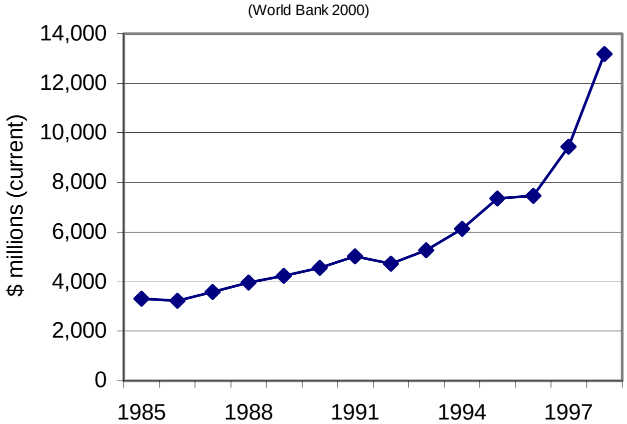
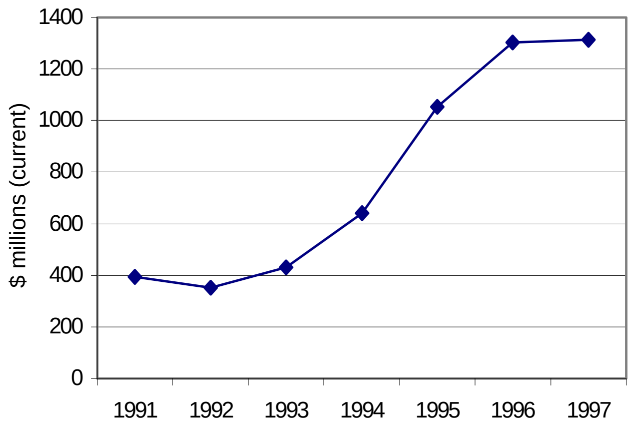


Figure 7: High-technology exports (World Bank 2000)

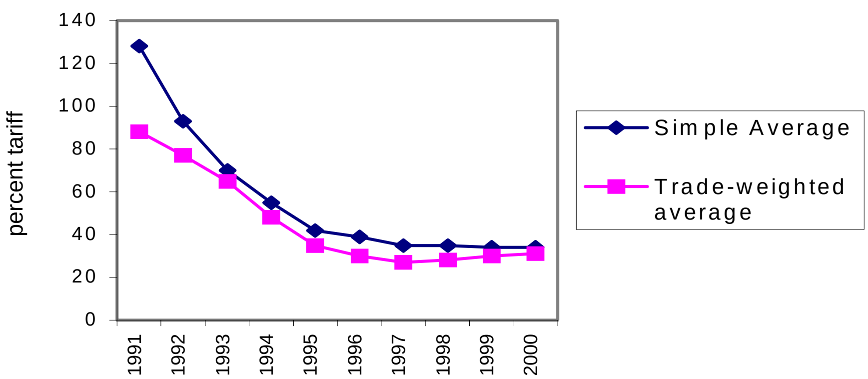


exports rising by 15 percent since 1990, albeit from a very low share of the overall market. Exports of manufactured goods have recorded positive growth rates since 1992-93, with the exception being 1998-99. Manufactures currently comprises almost half of total Indian exports (EIS 2000b). Agricultural and allied products, however, have been in decline since 1996, at an average of 3 percent per annum. This may be partly attributed to increased production (which is generating considerable production and storage inefficiencies) and reduced demand from neighboring Asian countries.

One of the greatest developments of India's export industry has been the growth of the Information Technology (IT) and services sectors. The development of these sectors illustrates the benefits derived from liberalization of foreign investment regulations, relaxation of import restrictions and expansion of private ownership. The services industry has grown in part as a result of favorable conditions including abundant supply of labor, low wages, and comparatively cheap technological costs. From GDP growth averaging 5.75 percent in the 1990s, the services sector contributed 3.25 percent, this compared to a contribution of only 1.5 percent from an average GDP growth of 3.75 percent between 1951 and 1980 (Kanda et. al 172). Service exports have risen from over $3 billion in 1985 to $14 billion in 1997 (Figure 6). Much of the development of this sector has been concentrated in Andhra Pradesh, Gujarat and Karnataka.

The IT sector has experienced dramatic rates of investment over the last decade and has grown at an average annual rate of over 50 percent (Figure 7). This industry currently comprises 15 percent of India's exports and brings in sales of over $8 billion annually. India's emergence as a major hub for software development (with exports anticipated to have reached $6bn by 1999-00) promises to lure foreign investors (EIU 2000). Exports from the hi-tech industry reached $1.5 billion by 1997-98 and $3.9 billion by 1999-00, supported in part, by a rise in the hardware sector including a significant increase in the domestic PC market (World Bank, EIU 2000). Estimates by the main trade association for the IT industry, NASSCOM, project that by 2008, India will export $50 billion in software and related services (Economist 6/01). A considerable share of this development has been concentrated in Tamil Nadu which has introduced "a far-reaching, industrial-friendly IT policy and set up a state-level IT Task Force to implement it" (Bajpai and Sachs 1999).

Figure 8: Average Tariffs (IMF 2000)



The reductions to tariffs and other qualitative restrictions have enabled imports to grow solidly over the decade. Figure 8 shows that rates on simple average tariffs have fallen from 130 percent in 1991 to slightly below 40 percent today, while trade-weighted average tariffs have fallen from 90 percent to almost the same level during the same period. Imports of items related to exports have risen considerably, although imports of capital goods have generally declined since 1996. Food and manufactured goods imports have also posted growth throughout the decade. India's current account deficit has fallen to approximately 1 percent of GDP by the end of the 1990s signals the positive achievements of reforms to international trade policy. India's admission into the World Trade Organization will have major implications for the trade industry in the future, likely removing remaining barriers to trade.

Impacts of Reforms on Poverty Reduction

The Indian government's enduring commitment to poverty reduction has resulted in nearly fifty years of household survey data on poverty. The National Sample Survey Organization (NSSO) has recently completed the 55th Round Survey on household expenditure. Results from past surveys indicated the average headcount index of poverty hovered around 50 percent from the 1950s to the mid-1970s. In the subsequent decade, 1977-78 to 1987-88, those numbers dropped by roughly 15 percent; this included large reductions in both rural and urban rates. However, this progress was reversed by the early 1990s, as economic conditions deteriorated and adverse agricultural conditions were experienced. The rural income poverty rate grew markedly between 1989-90 and 1992, but was reduced to 36 percent within the next two years (Planning Commission). The World Bank (2000b) notes that during this time "India reduced the depth and severity of poverty even faster than the poverty rate (the headcount ratio)," reflected by the improvements in the poverty gap and squared poverty gap indices. This signaled that "the process though which poverty was being reduced also improved the consumption of those far below the poverty line."

Table 2: Percentage of Population Below Poverty Line (Planning Commission)

Survey Year	Rural	Urban	Combined Average
1973-74	56.4	49.0	54.9
1977-78	53.1	45.2	51.3
1983	45.7	40.8	44.5
1987-88	39.1	38.2	38.9
1993-94	37.3	32.4	36.0
1999-00**	27.1	23.6	26.1

** using revised 30-day recall survey

The economic reforms initiated in 1991 were designed to correct for the macro-instability, encourage a higher growth path for India's future and improve the poverty situation on the whole. Preliminary results of the 55th Round Survey (1999-00) suggests that the poverty headcount has declined further since 1993-94, to 26.10 percent, on the 30-day recall and to 23.33 percent using a new seven-day recall.[7] The declining trend is supported by National Account Statistics (NAS), which suggests that consumption, including per capita cereal availability, has grown during the past decade (World Bank 2000b). The National Council of Applied Economic Research (NCAER) survey, Market Information Survey of Households (MISH), also indicates a declining trend in rural and urban poverty levels across the same period. Thus, there is strong evidence to indicate that India's economic growth has led to a decline in poverty as measured by consumption surveys and the National Accounts.

Yet, prior to the most recent NSS survey, data indicated that poverty had not improved significantly during the decade and disparities in welfare between states and regions had in fact grown. "Thin reports" conducted annually by NSS between 1994-99 indicated that mean per-capita consumption did not rise substantially, especially in the poor states of the north and east (an estimated 34 percent of the population remained below the poverty line), despite improvements in literacy and infant mortality rates. Past NSS results may, however, have under-estimated consumption growth, and thus poverty reduction, as a result of statistical inconsistencies. (According to the World Bank (2000b) "applying the NSS estimate of the distribution to the consumption figures in the National Accounts results in poverty falling in the nineties as well as the eighties.") The World Development Report 2000/01 calculates 44.2

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[7] See 'Methodological Innovations in the 55th Round of Household Consumer Expenditure Survey', Box 10.1, in Economic Survey 2000-01, Ministry of Finance.

percent of the population living below the $1 a day threshold, with the poverty gap at 12 percent, and 86.2 percent living below the $2 a day poverty line, with the poverty gap at 41.4 percent (based on 1997 survey data).

This trend within India may be clarified by examining interstate differences in poverty growth rates and social indicators. The World Bank (2000b) observed "a wide disparity in poverty across Indian states and their uneven progress in poverty reduction is a key feature of the evolution of poverty in India. In most cases, wealthier states remained relatively affluent and reduced poverty, while poorer states remained poor and made less progress in poverty reduction, but there are also cases where poorer states made major progress in poverty reduction and growth." Further, the report suggests, "if these poor states were to grow faster, poverty would fall more quickly."

To capture the relationship between economic growth and poverty reduction, Table 3 provides economic and social statistics for fifteen Indian states. This includes data on poverty trends, changes in expenditure on economic infrastructure (including power, irrigation and transportation) and social infrastructure (education and healthcare) as a percent change in gross State Domestic Product (GSDP), as well as changes in literacy rates, a key indicator of social development. In general, economic infrastructure expenditures declined marginally across all classifications of states between 1991-1998. This partially reflects recent reductions in subsidies from the Center, as well as new reforms implemented by the state governments themselves. Expenditure on social infrastructure declined in *reform-oriented* states (by over 1 percent) but increased slightly in the *intermediate and lagging reformer* states. Despite these limited contributions, literacy improved markedly across all states. Between 1992 and 1997, the growth of *reform-oriented* states averaged 5.64 percent; the poverty rate (1978-1994) declined by an average of 2.3 percent annually. In contrast *intermediate reformers* averaged growth of 3 percent from 1992-1997, while Orissa and West Bengal experienced average annual declines in their poverty rates of 2.7 and 4.2 percent respectively. Those states classified as *lagging reformers* experienced an average rate of growth of 2.69 percent from 1991 to 1997. Although there was a wide variation across these states, (-0.7% to 4.9%) all the growth rates fell below the national average. Between 1978 and 1994 the poverty rate declined by an average of 1.63 percent annually. Some conclusions about the causes and significance of this data are now discussed.

Table 3: State-Level Progress—Selected Social Indicators (Sources: Bajpai & Sachs 1999, WB 2000b Census 2001, Aiyar 2000)

State	**Growth Rate** GSDP p.c.	**Annualized % Decline in Poverty Rate**[a]	**Change in Economic Infrastructure Expenditure**[b]	**Change in Social Infrastucture Expenditure**[c]	**Change in literacy rate (%)**
	1992-1997	*1978-1994*	*1991/2-1997/8*	*1991/2-1997/8*	*1991-2001*
Reform-Oriented					
Andhra Pradesh	3.8	2.9	0.0	-0.4	17.0
Gujarat	8.4	1.0	-1.2	-1.0	8.9
Karnataka	3.4	2.1	-1.5	0.5	11.0
Maharashtra	7.4	2.7	-0.6	-3.6	12.4
Tamil Nadu	5.2	2.8	0.6	-0.6	10.8
Intermediate-Reform					
Haryana	2.6	~	-0.5	-0.1	12.7
Orissa	1.5	2.7	-0.7	0.2	14.5

West Bengal	4.9	4.2	1.0	0.0	11.5
Lagging Reformers					
Assam	1.0	~	~	~	11.5
Bihar	-0.7	0.4	-0.1	1.6	10.0
Kerala	4.9	3.7	0.3	-0.7	1.1
Madhya Pradesh	4.1	2.3	0.1	-0.8	19.4
Punjab	2.8	1.4	-0.9	-0.3	11.5
Rajasthan	4.9	1.1	-1.8	0.5	22.5
Uttar Pradesh	1.8	0.9	-0.7	0.5	16.7
a % population below poverty line	b total expenditure on power, irrigation, and transport as change in % GSDP		c total expenditure health/ education as change in % GSDP		

The factors contributing to the disparities in poverty reduction are multi-fold. The growth of real daily wages in rural areas—a vital aspect of the growth-poverty reduction relationship—appears to have declined in the 1990s, "suggesting that agricultural growth in the 1990s may have been less poverty reducing" than it was during the 1980s (World Bank 2000a). In the eastern regions of the country, which are predominately agricultural based, this would have a particularly detrimental effect on the poor. Rising inflation throughout the 1990s may also have hurt the nation's poor. In India, higher inflation is typically associated with meager harvests and a rise in food prices, which reduces food consumption, while at the same time raising wages less than price increases (World Bank 2000a). Inflation tax may hit poor populations (concentrated in the eastern and southern regions) harder than wealthier populations, given that relatively more of the poor's assets are in the form of currency. A sharp rise in food prices was also attributed to government mismanagement and reductions in social programs, which accentuated adverse agricultural conditions. The World Bank (2000b) suggests that "transitory shocks in food prices, such as at the end of 1998, related both to poor harvest and the rigid, still highly regulated food distribution system, continue to cause transitory increases in inflation". Between 1997 and 1998 and 1999 and 2000, exports of agricultural products declined due to "subdued international prices of agriculture based commodities, economic problems in Southeast Asia and Japan, and lower exports to Bangladesh" (EIS 2000b). Yet, adverse effects to the agricultural sector are not the only factors that may be stifling poverty reduction efforts. In India's experience, public expenditures have had important consequences for poverty fluctuations, as trends in poverty levels have often followed real per capita development expenditures (World Bank 2000a).

Reductions in central government spending on social services and economic development have slowed progress on poverty reduction in some regions. Cross-state comparisons indicate that those that have continued to expend resources on development programs, including those dedicated to poverty alleviation, have seen marked returns in poverty reduction[8]. This suggests that more efficient, though not necessarily greater, allocations of expenditure can have considerable positive impacts on poverty reduction. This evidence is critical to the economic future for India's poor in the urban and rural regions. While historically a vital condition for escaping poverty in India has been the creation of off-farm employment opportunities, this trend is transforming. Research conducted by Ravallion and Datt (1999) suggests "growth in the urbanized part of the economy was less significant in reducing poverty across states, reflecting

[8] See Bajpai and Sachs (1999)

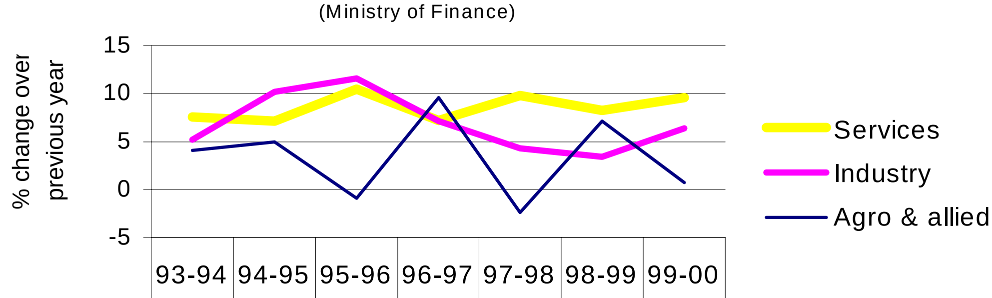
the capital intensive, import-substituting nature of India's industrial development, its requirements for skilled rather than unskilled labor, and labor market regulations that limit the growth of formal sector employment." Thus, further reforms of labor law, social programs and trade and industrial policy, in addition to reductions in implicit and explicit subsidies must remain foremost objectives of the central and state governments if economic prosperity is to reach rural, agricultural sectors, where the majority of the poor subsists.

Current Issues in the Reform Process

Recent developments including the Southeast Asian financial crisis, adverse shocks to the agricultural sectors, and rising oil prices have tested the resilience of the Indian economy and underscored its current strengths and weaknesses. Presently, the private and external sectors are making the most significant contributions to economic growth. The industrial sector, formerly one of the most highly regulated and protected facets of the Indian economy, has undergone a considerable degree of liberalization, which is reflected in the growing rates of investment. The services and IT sectors have also performed strongly during the past decade, (Figure 9) yet these industries cannot provide the millions of low-skilled jobs that will be necessary in the coming decades. Future economic growth must be inclusive of a greater portion of the nation's population and therefore will require further reforms and improvements in the agricultural sector. The variations in the real growth rate of agriculture during the 1990's must be better controlled in the future if conditions are to improve for the bulk of the population that still depends on this sector for its livelihood.

Figure 9: Sectoral real growth rates in GDP, at factor cost

(Ministry of Finance)



	93-94	94-95	95-96	96-97	97-98	98-99	99-00
Services	7.6	7.1	10.5	7.2	9.8	8.2	9.6
Industry	5.2	10.2	11.6	7.1	4.3	3.4	6.4
Agro & allied	4.1	5	-0.9	9.6	-2.4	7.1	0.7

The 1999 election sparked renewed calls for fiscal reform and renewed liberalization measures. A proposed Fiscal Responsibility Act includes new bankruptcy and insolvency law to hasten the process for closing loss-making firms, labor market legislation to ease termination of employment contracts, lucrative fiscal incentives for firms investing in Special Economic Zones, and several additional provisions (EIU 2000). Such measures are surely needed to induce economic growth and alleviate the rapidly deteriorating fiscal position. Yet there is also a need for greater fiscal discipline at the state level. The combined budget deficit of the state governments currently accounts for nearly one-half of the nation's total deficit (EIU 2000). This varies widely, however, from state to state and has become a strong source of resentment among the better performing states. The long-term opportunity to strengthen the performance of the Indian economy rests on the implementation of necessary economic reforms and requires the cooperation and coordination of all levels of government.

Conclusion

Initiation of reforms in 1991came after four decades of highly centralized planning had proven economically unsustainable. The decision to reduce fiscal expenditure, privatize industry, open up foreign investment opportunities and liberalize trade was fraught with obstacles imposed by the central and state governments, bureaucracies, and interest groups. Further, on-going extraneous developments placed additional pressures on the liberalization process. As a result, progress to fully implement the reform initiatives has been limited in some areas, while many undertakings were substantially curtailed over the course of the decade.

As India's experience over the past decade illustrates, the pathway to social development and, crucially, poverty reduction, rests with the capacities of states to achieve sound economic futures built upon high levels of investment in human development and adequate infrastructure. Although the discrepancies in available data highlight the urgent need for increased accuracy and coordination between data sources, economic growth and reform policies experienced in the early years of reforms suggest that poverty levels were reduced in the country, though concentrated primarily in the *reform-oriented* states. Enhancing the scope and breadth of reform measures, particularly those that address the needs of rural, agricultural regions, will further economic growth and ultimately lead to reductions in India's poor.

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